

Elder Law: Inheritance tax in Pa. takes varying chunks

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(Part 1: The State's Share)

It's inevitable, as they say.

Mr. and Mrs. Adams worked their whole lives to save a modest nest egg for their golden years. They have been proactive and prepared a basic estate plan that incorporates the usual documents that we advocate regularly in this column (wills, powers of attorney and health care directives).

However, when it came to discussing taxes, the Adamses were surprised to learn of the numerous potential tax liabilities at both the state and federal level. With all the changes afoot in our country involving the economy, debt ceilings, funding wars and other financially sensitive issues, this issue invariably boils down to funding our government with taxes. So, we thought it would be a good idea to review the current status of so-called death taxes in Pennsylvania as well as at the federal level, including possible changes to come.

The Adamses are certainly aware of their obligation to report and pay their fair share of annual state, federal and local income taxes. This column is devoted to the estate and Pennsylvania inheritance taxes that are triggered at death. We'll leave the income tax discussion to the accountants.

Pennsylvania is one of only a handful of states that still imposes an inheritance tax at death. In fact, the last time we checked, there were less than a dozen states still levying such a tax. This means that even after a Pennsylvania resident has satisfied his annual income tax obligations, his assets (home, car, bank accounts, IRAs, mutual funds, etc.) are still subject to another tax at death. In our state, the Pennsylvania Department of Revenue is in charge of collecting this tax. The tax liability is based on the value of the decedent's assets on the date of death, as well as whom the transferee/recipient of the asset is. There is no "floor" or "ceiling" amount to this tax, although there are various deductions and credits available as well as certain assets that are exempt from this tax.

Pennsylvania has four basic inheritance tax rates. They are:

- 0 percent for assets passing between spouses;
- 4.5 percent for assets passing to lineal relatives (children, grandchildren, parents, grandparents, etc.);
- 12 percent for assets passing between siblings; and
- 15 percent for assets passing to anyone else.

So, when Mr. Adams dies, all of his property passes to his wife free of Pennsylvania inheritance tax. In fact, if Mr. Adams held all of his assets jointly with his wife or named her as a designated beneficiary on his beneficiary designatable accounts, an inheritance tax return is not even required. However, when Mrs. Adams dies and leaves her estate to her children, a tax in the amount of 4.5 percent of the value of all the assets she had an interest in on her date of death will be levied.

The inheritance tax filing rules require that the tax is paid and the tax return filed within nine months following the date of death. Pennsylvania gives a 5 percent discount on the amount of tax owed if it is paid within three months following the date of death, (called the "discount date"). Let's assume that the Adamses had no children and Mrs. Adams left her estate to her beloved sister, Marge. Marge would then owe a 12 percent tax on the value of everything she received from her sister. Some would say this is a significant tax given that the assets that are being taxed have or will already be taxed for income tax purposes. Therein lies a planning opportunity.

Suppose Mrs. Adams decides she's going to "beat" this perceived injustice to her sister by giving her sister all of her money and home a few months before her death so that there will be no trace of the assets in Mrs. Adams' name. Sounds like a great strategy -- but, not so fast. Pennsylvania has a one year "look back" period for transfers made by a decedent within the last year of life. This tax provision is meant to discourage "death bed" transfers by those knowing their mortality is imminent.

Since none of us has a crystal ball, this is not the best estate tax planning technique (not to mention the total loss of control over all of Mrs. Adams' hard earned assets simply to avoid taxes).

You may wonder, "How does the state find out about this money anyway?" Well, big brother/sister is watching, and banks, for example, are required to report a decedent's account holdings directly to the Department of Revenue when the bank learns of a customer's death. This triggers a series of legal requirements relative to the bank account and the running of the filing deadlines outlined above.

There is some good news, sort of. Life insurance proceeds are not taxed in Pennsylvania, regardless of the amount. However, as we will see in our next column, the federal government does tax life insurance owned by the decedent, with a variety of exceptions, deductions and other intricate considerations.

So, you're not happy with Pennsylvania's imposition of a 4.5 percent inheritance tax on the items you want to leave to your kids? Stay tuned because the federal estate tax rate can be 10 times this amount (roughly 45 percent), and Congress is inching toward a major decision on the future of this tax at the end of 2012.

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